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CURRENCIES AND CREDIT MARKETS

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"We are starting to worry that the rumbling and grinding we've been hearing from New England may be the start of a full-blown credit crunch. A crunch caused not by U.S. Federal Reserve policy but by that most terrifying force of nature, frightened bankers in full stampede."

Wall Street Journal
March 15, 1990

HIGHLIGHTS

The most significant trend in the United States since the 1987 crash is that "excess liquidity" has been in a sharp decline. A silent, hidden credit crunch is taking place.

Considering the fragility and vulnerability of the U.S. financial system, declining liquidity portends a recession and a sharp decline in asset prices as "excess liquidity" is drained away. There is little real economic strength to be found anywhere.

Introducing the D-mark into East Germany should not present any serious inflation risks provided that the release of savings is phased out over time. And that is sure to happen.

A world capital drought isn't likely. We doubt that anyone will throw billions upon billions into the eastern European countries. Some of these countries simply don't have the necessary infrastructure for that to happen.

German bond yields have risen out of all proportion to the modest inflation and budget implications of unification. In general, European long-term interest rates may have peaked. Not only are German bonds attractive, but so are French and Dutch bonds.

It has taken little more than two months to shatter the myth of Japanese financial power. The highly critical remarks we made about Japan's huge speculative bubble in the last several months have been vindicated all too fast and dramatically.

Japan's lucrative game of playing international interest rate differentials has been squeezed by the rise of European rates to U.S. levels. The closing down of Euro-credit markets to Japanese borrowers is the main cause of yen-weakness.

The Japanese policy dilemma worsens. Stabilizing the bond market requires a stable yen. But the only way to firm the yen is with higher interest rates, which, in turn, would almost certainly prompt a further fall in equities.

The most worrying question is what might happen to Japan's economy and its financial system should the steep fall in stocks spread to the high-priced property markets.

(Editors Note: As our readers well know, Europe is in the midst of a metamorphosis. The related developments should have large implications for the world financial markets. European monetary unification (EMU), an event already being trial-run by the German economic and monetary unification (euphemistically called the Gemu), and a pan-European central bank dubbed the Eurofed, could be some of the major financial landmarks of the decade. The impact of all this will be significant for currencies and credit markets. We intend to continue our emphasis on Europe as situations may call for without losing sight of epic developments in Japan, United States or elsewhere.)

MARKETS BETWEEN THREE CORNERS

Worldwide, market attention remains fixed on the three main issues we addressed in our last letter: the many horror stories predicting adverse implications of a German monetary unification, a quickening optimism on U.S. economic growth prospects, and the Japanese financial cataclysm. Each of these elements make for fascinating reviews. To have three such important developments occur in a decade would make rich financial history, let alone in one year. We again need to review all three issues.

GERMANY: AN INFLATIONARY CAULDRON?

With an ill-concealed spirit of vilification, some British broker analysts have done their best to convince markets that a German monetary unification will be an inflationary and fiscal disaster. Common to most of these pessimistic reports, no less, is the assertion that Chancellor Kohl is going to force the Bundesbank to finance the rebuilding of East Germany by resorting to the printing press. This fable, of course, concludes that inflation will devour the land.

Anatole Kaletzky beautifully captures the shallowness of the consensus thinking regarding monetary unification in his comment on this subject in the Financial Times (February 25, 1990). He says, "*The fundamental analysts in the financial markets seem to have been even more short-sighted than usual in their assessment of what monetary unification might mean ... Fortunately for the world financial markets, these arguments involve fallacies that are egregious even by the standards of Wall Street and the City of London.*"

All the horror stories about Germany's future boom in inflation and budget deficits rest on the cornerstone that the Bundesbank has "capitulated" to the politician's call for a rapid monetary union. The following quote from the letter of a U.S. brokerage firm is typical: "*The Bundesbank's inability to insist on specific terms and conditions for this union will further damage its credibility, resulting in a loss of confidence on the part of financial markets*". Many of these comments show a deep ignorance about West German domestic affairs. A brief glimpse, we think, will allay some unfounded worries.

First of all, the idea of the Bundesbank having "capitulated" to the politicians is a fundamental fallacy. In Germany, just as in any other country, responsibility and decision-making over currency matters rests exclusively with the government. Who, in fact, decides on the establishment of the European Monetary Union? Governments do, and not the central banks. One might well say that it's always the government that sets the legal framework for a currency. There is nothing new in that, nor is there anything peculiar about the Bundesbank having no official power to orchestrate a monetary unification.

However, after a currency has been established, it becomes the task of the central bank to manage and steer the currency with its particular monetary instruments. Only then, when it comes to the

administration of monetary policy proper, does the Bundesbank's famous independence come into play. And in that task, is there any reason to believe that the tight-fisted grip of the Bundesbank will change?

Although it may not need saying, it is obvious, of course, that the government and the Bundesbank do cooperate in formulating the introduction of the D-mark into East Germany. The bank's vice president, as a matter of fact, heads the government's commission on currency matters.

On the matter of Mr. Kohl's agenda, we would say that his policy record hardly justifies any hysterical fears over possible fiscal recklessness. Since he assumed the chancellorship, Germany's public sector deficit has been trimmed from 5% of GNP in 1981 to a level of less than 1% of GNP last year. Public expenditures, as a share of GNP, have been reduced from 50% to 45%. In light of this excellent record, we think that he and his government deserve some benefit of the doubt on the question of future policy until there is some proof to the contrary.

Facing possible elections in 1991 for a united German parliament, Mr. Kohl surely wants to avoid disappointing 16 million East Germans. However, he must first attend to a West Germany election this December. There he will likely have to persuade 61 million West Germans that unity will not cost them too much. Given the German obsession with sound money, it is really more than naive to believe that Mr. Kohl might even think of buying a German economic and monetary unification with inflated money or rampant public borrowing. That is precisely what his adversaries are hoping and waiting for since it would definitely cost him the election.

It is quite easy to recognize the root cause of the opinion-split on Germany's monetary unification. Opinion depends on whether or not one believes that monetary and economic reform - combined with massive capital infusions from the West - will successfully put the East German economy on a path of new dynamism and productivity growth on the up and up.

Allaying Prevalent Fears. As it is, however, the prospect of German monetary unification has set off ripples of alarms as markets brace themselves for exploding budget deficits and a sharp expansion of the West German money supply.

The main sources of inflation anxiety are three claims: firstly, that a conversion of worthless East German savings into D-marks will bloat West German money supply, stimulate pent-up consumer demand, and send inflation and interest rates into the stratosphere; secondly, that economic and monetary unification will trigger huge capital needs in order to finance East Germany's reconstruction. (A number of British reports have predicted capital requirements of DM 1 trillion over the next 10 years or so); and thirdly, that immense social obligations and costs for infrastructure investment in the East will swell Bonn's annual borrowing requirements by DM 100 billion or more a year.

The bottom line to all these reports is that an economic and monetary union will afflict Germany with every kind of evil; accelerating inflation, a plunging trade surplus, an exploding budget deficit, further rises in interest rates to 10% and higher, and - last but not least - a slumping currency. And not that the German-related evils will be just restricted to Germany. It has also become a standing argument that all of this fallout - along with the opening of Eastern Europe - will swamp world financial markets. With capital requirements seen in astronomic dimensions, it is expected that interest rates

will be boosted worldwide. Even Mr. Greenspan has given voice to this idea.

Worry #1. Savings Conversion. In our view, though, these worries are all sheer nonsense. First of all, let's put things in perspective starting with East Germany. Measured by nominal GNP, its economy is less than \$300 billion ostmarks, barely 15% of the West German economy. It commands a labour force one third the size of West Germany's at one third the productivity level. Since East German wages denominated in ostmarks are only approximately one-third that of the West's denominated in D-marks (at a gross monthly average of 1,290 ostmarks versus 3,876 D-marks), the existing wage gap corresponds to the productivity gap.

One thing is clear. If the black market exchange rate of 1-for-5 were applied - as some would have it - East German wages would be at levels equivalent to those of under-developed countries. The black market rate is simply not a useful bench-mark in this regard.

In choosing the exchange rate, authorities need to steer between two crucial requirements: avoiding inflation on the one hand, and preserving competitiveness on the other.

So far, attention has been focused on the conversion rate for savings. The problem is that savings do not stand in isolation. These savings have a counterpart mainly in the debts of the state-owned corporations. For competitive reasons, there is agreement that these debts should be substantially reduced by a conversion rate of two-to-one or so. An exchange rate of one-to-one would leave a gap of DM 50 billion to 100 billion. The lower the conversion rate, the higher the debt-load.

In the meantime, the Bundesbank has caused quite an uproar with its proposal to convert all debts and savings at a rate of two-to-one. However, individual bank accounts of up to 2,000 ostmarks per person would be converted at a one-to-one rate. These amounts would be accessible immediately.

But as part of the proposed combination, the Bundesbank suggests that East Germans should be guaranteed a stake in the vast state-owned assets which would be privatized, thus compensating the savers for their losses on the currency conversion.

All-in-all, this is very much in line with what we wrote in our last letter. Right from the beginning it was clear that part of the East German pool of savings would be frozen in one way or another in order to prevent a run-away consumption binge. It was obvious that the best way to do this was to privatize the vast mass of state-owned assets, just as the Bundesbank has now proposed.

Will the new Germany be an inflationary place with a weak Bundesbank as some commentators like to forecast? Not hardly. If the entire stock of East German savings were converted at the liberal exchange rate of one-to-one tomorrow, that would add about 15% to West Germany's money supply. But, at the same time, though, unification would add approximately 15% to German GNP, too. If as much as 40-50% of East Germany's savings are frozen, the probable increase in the money supply will be no greater than 10% and will be more than matched by the additional GNP.

Introducing the D-mark into East Germany should not present any serious inflation risks provided that the release of savings is phased out over time. And that is sure to happen. Besides . . . there is the safety net of the trade balance. Much of the demand pressure will likely find a release by running down the trade surplus, with imports rising substantially. Internal prices would hardly rise

at all. In the world today, what country can better afford an import boom than Germany?

Now, what about the impact on the rest of the world and the many international analysts that have concluded that a German unification - along with the opening of Eastern Europe - will tax the globe's finances with enormous capital requirements and spiralling interest rates? Again, we can only plead to preserve perspective.

Worry #2. Impact of Capital Requirements. We doubt very much that anyone - whether banks or corporations - will carelessly throw billions upon billions into the eastern European countries. For some of them, there simply isn't the necessary infrastructure to allow that to happen. To quote the London Economist, whom we agree with on this point: *"Eastern Europe will just get the modest flow of whatever direct investments and joint venture Western businessmen will risk there. East Germany aside, these capital flows will amount at most to a few billion dollars a year. That won't bring capital drought in the rest of the world."*

To be sure, East Germany is a different case. There are numerous corporations in West Germany eager to invest over there. Yet here, too, certain limits are obvious. These limits do not lie in the willingness of West Germans or the potential capital supply, but rather in the capacity of an economy of such modest size to absorb new real capital investments.

One thing is sure. There is no way that an economy of DM \$300 billion can absorb the annual capital inflow of DM 100 billion in real capital investment that has been so widely predicted. To start with in our view, DM 50 billion - almost 20% of GNP - would already be on the high side.

DM 50 billion or even DM 30 billion a year is enormous to East Germany, but what is it to West Germany and the world's financial markets? It's equivalent to one half of Germany's 1989 savings/current account surplus, one-half of West Germany's annual GNP growth, or one-tenth of current annual fixed investment.

Bearing these figures in mind, one can only ask, "What's the problem?" Not all of the potential capital demands we cited will fall on the capital markets. East Germany, after all, will also contribute some savings of its own. Above all, investments in East Germany will assuredly be partly offset to an extent by lower investment in the West and perhaps even in the rest of the world.

Worry #3. Budgetary Impact. The only troubling aspect that remains is the third worry of unification: that the financial consequences of rising social obligations could be severe. Here, too, we find that markets are again exaggerating the numbers. What is obvious is that two factors are generally being ignored. One oversight is the very low level of wages and pensions in East Germany. The country's 2.7 million retirees only draw an average monthly pension of 430 ostmarks. The second omission is that the East German state will have revenues of its own.

According to estimates from competent sources, there may be an impact of DM 25-30 billion per year over the next year or two as infrastructure and special security bills of the East are assumed by the federal budget. But by no means would that imply an equivalent increase in the budget deficit. First of all, the booming economy would buoy revenues; and second, there would be considerable offsets and shifts within a given budget. The terms of the original division of Germany, too, has meant considerable costs such as annual subsidies to West Berlin and isolated border regions as well as

payments to East Germany. The finance ministry estimates these sums at roughly DM 40 billion. And, these figures don't even include possible savings in military expenditures.

As a result, the West German budget deficit may rise by DM 10 to 20 billion per year, if that much. But even if it would rise by a higher DM 30-40 billion, that, too, could hardly put worldwide pressure on interest rates. That amount, after all, is less than the margin of error in the U.S. budget deficit presently.

Above all, we want to emphasize this: the rise in German bond yields is out of all proportion to the modest inflationary or budgetary implications of unification. As German rates set the tune for other European bond markets, European long-term interest rates in general may have peaked. From this point of view, not only are German bonds attractive, but so are French and Dutch bonds.

Higher Interest Rates: Who Did it? Many foreign commentators complain that Germany is driving up world interest rates with its headlong rush into unification. We see a completely different causality. The sharp increase in German interest rates may have been an essential part of a process that will withdraw German capital from the international markets because it is needed at home to rebuild the East German economy. To attain this goal, foreign borrowers at higher interest rates need to be crowded out of the market for German savings. Unfortunately at the moment, since some foreigners are still willing to borrow at higher rates, that requires higher competitive rates in Germany. In other words, it isn't Germany that is forcing higher interest rates on the deficit countries, but it is the deficit country's that force Germany to adjust to their high interest rates.

We think that the current phase of high German interest rates is transitory. Once the hysteria about unification and the role of the Bundesbank wanes, there will be a stampede of foreign investors into German and other European hard-currency bonds, driving long-term interest rates down and the D-mark up. But, a booming economy will limit the extent of any rate declines. As a matter of fact, the reversal in capital flows has already started with a vengeance as the following table shows.

| WEST GERMANY NET LONG-TERM CAPITAL FLOWS (Billions, DM) | | | | | |
|--|--------------------|--------------------|--------------------|------------------|---------------------|
| TOTAL ANNUAL | <u>1987</u> | <u>1988</u> | <u>1989</u> | | |
| Total | -23.2 | -84.9 | -24.9 | | |
| Portfolio | +8.0 | -65.1 | +4.0 | | |
| TOTAL QUARTERLY | <u>1Q</u> | <u>2Q</u> | <u>3Q</u> | <u>4Q</u> | <u>JAN80</u> |
| Total | -33.1 | +0.4 | -6.1 | +13.8 | -0.6 |
| Portfolio | -28.2 | +2.9 | -0.4 | +21.8 | +2.4 |

Uncertainty over the implications of monetary unification will persist for some time probably. That may negatively impact German bonds and the D-mark temporarily. However, at the end of the day, it will become clear that the government will maintain its traditional high standards of financial prudence just as the Bundesbank is the vigilant guardian of the D-mark and the country's "low-inflation" record.

UNITED STATES: HOLLOW OPTIMISM

While many reports written on Germany's economy are tinged with gleeful pessimism, those written on the U.S. are pure wishful thinking. So far, the complacency on Wall Street has not yet been seriously shaken. What has saved the U.S. financial markets - at least thus far - is the strong dollar: extremely strong against the yen and modestly so against the D-mark.

The dollar has been underpinned by the perception that U.S. economic data are showing signs of recovering growth thus excluding the possibility of a further Fed easing. Some already suggest that the Fed's next move will be towards tightening. In addition, a collapsing yen, imploding Japanese financial markets, and German inflation-mongering have also helped the dollar, if for no other reason than by default.

Apart from the favourable but temporary external influences, the key question for currency markets over the next two or three months is the U.S. economy. Will an economic rebound - of which markets have so quickly convinced themselves - materialize and prompt tighter money?

Nothing Has Changed For the Better. As we have said before, the U.S. economy is slowing and is likely to weaken further. Due mainly to the gross weather-related distortions, some statistics for January and February *appear* quite strong. Yet, none of the fundamentals that support economic growth have changed for the better. Temperatures in these two months were the warmest in the past century. Once the effects of the seasonal distortions are isolated from the data, the downturn in economic activity becomes readily apparent.

It's amusing to observe the biases of commentators reacting to weak data. Everything that goes up is greeted as proof of a rebound, while everything that goes down is explained away. Here's an example. When it was announced that building permits issued during February had plummeted 25% to an annual rate of 1,308,000, it was immediately discarded as an aberration. True, however, was the original aberration of a prior steep rise of 26.8% in January, which had been joyously taken at face value.

It also should be noted that the United States is the only country in the world that annualizes some data. Quarterly GNP statistics are notable examples. Great fuss has been made of the fact that U.S. real GNP growth for the fourth quarter of 1989 has been successively revised upwards from 0.5% to 1.1%. In reality, it is only the annualization that conjures up the impression of a major improvement. Without the multiplication, the improvement would have been a minute 0.1% to a respective rate of 0.3%. In contrast, at about the same time it was reported that Germany's real GNP had increased by 1% from the third to fourth quarters. However, that figure was not annualized as per usual. In America it would have been presented as a growth rate of 4%.

The obvious problem with annualization is that it grossly compounds any distortion. In the last letter

we mentioned that more than half of U.S. GNP growth in the fourth quarter was accounted for by an unusual rise in heating costs (\$6 billion) which was due to the extremely cold December. In response to that comment we got a call from a U.S.-based oil company claiming that it couldn't have been possible. "No", we answered, "it's American statistics that make it possible". Without annualization, the raw figure would only be \$1.5 billion. This amount, the caller agreed, is feasible and added the following closing remark: *"I only believe in statistics that I have falsified myself."*

No Strength Found Anywhere. Not a single demand component shows any strength. The first thing we challenge is one of the key arguments supporting the legendary resilience of the U.S. economy. That is the popular argument that the large and growing service sector will always generate sufficient job and income growth for consumer spending to keep the economy afloat regardless of weakness in investment or exports.

The irony is that personal consumption has already been "dead in the water" for five full months. In the fourth quarter of 1989, total personal consumption only grew \$2.5 billion even with the benefit of an upward revision in the earlier-mentioned heating costs to \$9.3 billion (at an annual rate). Since then, personal spending declined 0.1% in January and stayed flat in February. Weakness in consumer spending is now into the sixth month, yet everybody continues to speak of a strong consumer bailing out the economy.

Where else is there real or potential strength? Exports? The monthly figures since March 1989 are shown in the next table. This unimpressive export performance is particularly lacklustre considering the background: a booming world economy and weak domestic demand. When would ever be a better time for the United States to improve their exports if not under these favourable conditions?

US MONTHLY EXPORTS
(U.S., Billions)

| 1989 | |
|-------|--------|
| Mar. | \$30.1 |
| Apr. | 30.8 |
| May. | 30.5 |
| June. | 31.3 |
| July. | 30.5 |
| Aug. | 30.6 |
| Sept. | 30.7 |
| Oct. | 31.0 |
| Nov. | 30.4 |
| Dec. | 31.1 |
| Jan. | 32.1 |

Then what about business investment? With profits and cash flows down sharply and corporations facing sluggish demand on the one hand and higher labour costs and interest rates on the other, any upturn here seems unthinkable.

In February, non-defense capital goods orders dropped 5.7%, extending a January plunge of 13.7%. In the eight months ended February 28, orders placed with U.S. machine tool manufacturers were down 25%. About half of U.S machine tool purchases last year were imports.

Employment Growth Out of Line. One single item is left as supposed evidence of a rebounding U.S. economy. That's the recent big gains in employment of more than 700,000 in January and February. Some have been quick to calculate that this strong job growth must translate into about 3% GNP growth for the first quarter.

That this one isolated sign of strength has become the main guide for forecasters and markets is really ridiculous, as we've often mentioned before. Any schoolboy economist should immediately recognize that these big job gains grossly conflict with all the other data such as stagnating consumer

expenditures, services, business investment and exports.

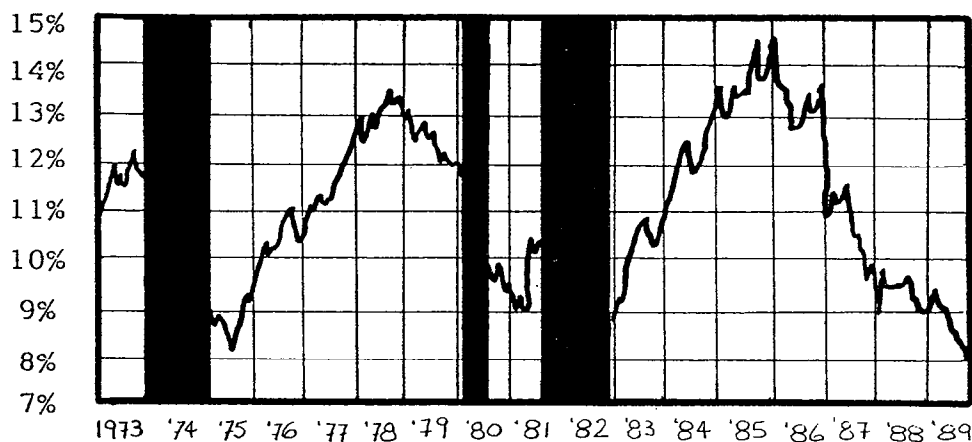
Given all the permeating stagnation, these job gains can only have two explanations. Either they, too, are just another statistical fluke or it reflects unjustified bullishness on the part of employers in the service sector where all these job gains are taking place.

To say that the U.S. economy is gathering strength is just plain nonsense. Wall Street has a nice way of looking past every problem by simply arguing that the worst is over. To us, the whole discussion about U.S. economic trends has degenerated into a ridiculous number game. Without the annualization gimmickry and many other dubious items, what remains is a feeble economy on the edge of recession. To moderate that recession would have required easier money long ago. However, there are two formidable obstacles to that avenue: the vulnerable dollar and the increasingly dreadful inflation numbers. Consumer prices, excluding food and energy, rose at a 7% rate over the past two months.

From Asset Inflation to Asset Deflation. Weak data isn't the only reason why we think that the economy is rapidly deteriorating in the United States. Another important reason is evident in the chart that follows. It reveals a virtual collapse in credit and debt growth.

U.S. Debt Growth Rate Cools Off

Year-to-year growth rate of domestic financial debt: monthly data in percent, shaded areas indicate recessions.



Source: Wall Street Journal, Federal Reserve Board

Over the past year, U.S. debt (including government, business and consumer) has increased 7.6%. That was the lowest growth rate in 19 years. Recently, moreover, debt growth has further decelerated to an annual rate of 6.4% for the three months ending February.

Credit is the driving force behind the economy and asset markets. Credit is generally used to buy something. That can be either goods or services - the national product - or existing real and financial assets.

In past years, credit creation far surpassed nominal GNP growth in many countries. The difference between credit growth and simultaneous GNP growth may be defined as "excess credit" or "excess liquidity".

In the United States, for example, credit and debt grew 150% between 1980 and 1989. During the same period nominal GNP only increased 100%. But many other countries - including Britain, Australia, Canada, and Japan and its smaller neighbours - staged even greater excesses.

Everywhere, the euphemistically called "excess liquidity" poured into property, stocks and the take-over of whole corporations. The soaring prices of these assets (meanwhile known as asset inflation) accompanied by low inflation in current goods and services created prodigious wealth seemingly from thin air.

The Silent Crunch. The important point to see now in the United States, is that since the 1987 crash, "excess liquidity" has been in a sharp decline. Recently, credit and debt creation - now down to a year-over-rate of 6.4% from levels of 14% in 1984 to 1985 - barely matches GNP growth. In other words, the great credit machine that fuelled the asset price inflation has stalled. Relative to GNP, credit is tighter than ever.

Months ago, we already posed this question: Does this sharp slowdown in lending emanate from the demand or supply side? Our answer was that it must be slowing credit demand since banks appeared to have ample reserves to expand their lending. Far from surprising to us is that a new explanation is gaining acceptance. The reasoning goes that since the banks are now over-loaded with bad debts, the financial system has lost its flexibility. More precisely, banks are asking potential borrowers for more collateral all over the country, are turning down loans, and are even scrutinizing long-time customers. So as we say, a silent, hidden credit crunch is taking place.

Considering the fragility and vulnerability of the U.S. financial system, what this silent, but relentless credit squeeze portends should be clear: first, a recession; and second, a sharp decline in asset prices as "excess liquidity" is drained away.

JAPAN'S TROUBLES GO DEEPER

It has taken little more than two months to shatter the myth of Japanese financial power. The highly critical remarks we made about Japan's huge speculative bubble in the last several months have been vindicated all too fast and dramatically.

It is a common observation among market analysts that the steep fall of the yen is due to the outflow of long-term capital exceeding the current account surplus. However, as we showed in the past two letters, this pattern has been true for many years. Yet, the yen remained fairly strong during that time. What then, is the cause for the yen's present weakness?

As we already alluded to in a previous letter, the answer lies in the fact that Japanese banks and institutional investors have always financed the greater part of their large foreign investments by foreign currency borrowing mainly in the Euro money and bond market. With these cheap borrowings, the Japanese have then played international interest rate differentials.

This lucrative game has suddenly been spoiled by the Bundesbank's monetary tightening which has pushed up German interest rates to U.S. levels. Now that Euro money has become too expensive, Japan's continuing large capital outflows have to be financed mostly from domestic sources. Essentially, that depresses the yen and drives up yen interest rates.

Furthermore, the crowding out of Japanese Euro-borrowing coincides with a drastic shrinkage in Japan's current account surplus. After recording a surplus of \$57 billion in 1989, it is now running at an annual rate of \$40 billion and less than half the \$87 surplus in 1987.

We have always argued that there is a simple reason for the yen's weakness: excessive money creation. While the whole world has tightened, money expansion in Japan (still running at 11.5% year-over-year) continues to outstrip nominal GNP growth by a wide margin. What has perplexed many people is that a one percentage point rise in the discount rate has failed to stabilize the yen. In reality, that move was more of a sham since short-term market rates have actually eased since then. Before that, the short-term interest rate differential between the yen and the dollar was down to 0.8%. Now it's back up to 1.2% in favour of the dollar.

Despite a booming economy, Japan still has the lowest interest rates in the world. Yet, the authorities shy away, though the reasons for tightening are virtually multiplying. The list includes buoyant domestic demand, rapid money growth, a weak currency, rising prices as well as import prices, a collapsing trade surplus, and a tight labour market with accelerating wage rises.

We wondered all the time why the Japanese authorities are so faint-hearted in face of all these facts. Compare their behaviour with the Bundesbank's aggressive action. One reason for their over-caution is clear: fear of pricking the enormous stock and land price bubble which could carry unforeseeable consequences for the economy as a whole. At the same time, however, there are beginning signs that the economy is losing momentum.

Having failed to react in time, the policy dilemma is now getting worse and worse. In order to stabilize the bond markets, authorities first need a stable yen. But the only way to stabilize the yen is with higher interest rates, which, in turn, would almost certainly prompt a further fall in equities. The most worrying question is what might happen to the economy and the financial system if the steep fall in stocks spreads to the property markets.

SUMMARY CONCLUSIONS

Germany has a booming economy and now confronts the Herculean task of integrating East Germany. Japan struggles with capital flight and the legacy of years of monetary overexpansion. And in the United States - as well as some other countries such as England, Canada and Australia - recession is knocking at the door. Policy requirements differ as never before.

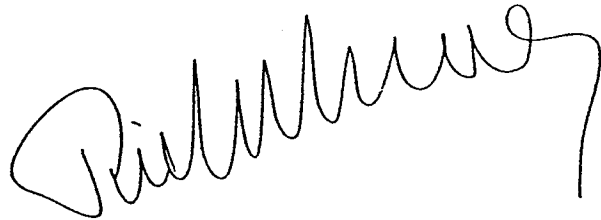
Continental Europe, led by Germany, enjoys the highest economic growth and the lowest inflation. Not only that, it has also avoided the speculative excesses that have ravaged the Anglo-Saxon and Far Eastern countries. Continental Europe is an island of new-found economic dynamism and financial stability.

The important question about Germany is not what East German integration will cost the government,

but whether the Bundesbank will undertake whatever action is necessary to contain the inflationary spill-over of a monetary union. Without any doubt, we think the Bundesbank will. Therefore, the D-mark is bound to rise considerably.

The rise of the D-mark will be fuelled further when the markets begin to realize that the supposed rebound of the U.S. economy was nothing more than a statistical mirage. Sooner or later, the Fed will have to ease further regardless of whether inflation has moderated from the current 5% range or not.

Japan is on the firing line. Its economy is still strong (though now weakening). However, years of extreme monetary looseness and speculative excesses have undermined its financial stability. Bonds, stocks and its currency have collapsed. Each weakness feeds off the other. In short, the outlook is bleak. As long as the capital flight continues, foreign markets may remain decoupled. However, that cannot last forever.

A large, stylized handwritten signature in black ink, likely belonging to Dr. Kurt Richebächer, is positioned in the center-right of the page.

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